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Bank of North Dakota

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Capital

CREDIT RATING

AA-/Stable/A-1+

Outstanding Rating(s)

Counterparty Credit

AA-/Stable/A-1+

Certificate of deposit

Local currency

AA-/A-1+

Credit Rating History

Aug. 26, 1994

AA-/A-1+

Sovereign Rating

United States of America

AAA/Stable/A-1+

Major Rating Factors

Strengths:

- Support from the state of North Dakota
- Good capitalization
- Moderate financial risk

Weaknesses:

- Large indirect exposure to agriculture
- Risk profile subject to shifting political environment

Rationale

The ratings on Bank of North Dakota (BND) reflect a guarantee of its obligations by the state of North Dakota, whose general obligations are rated 'AA-/Stable/--'. BND is owned, controlled, and maintained by the state of North Dakota. By statute, BND is defined as the state of North Dakota doing business as BND. The bank is viewed by the state as serving an important role in promoting the state government's economic development and stabilization policies.

While the rating is based on the guarantee, overall performance at the bank has been good and BND is conservatively managed. Capital measures are a strong point for BND with adjusted total equity capital ratios consistently in excess of 8.5%. State authorities and bank management appear to have struck a reasonable balance between social and business objectives, and financially sound business management. Nevertheless, any significant changes in the political environment of the state resulting in legislative change could materially affect the bank's risk profile. Standard & Poor's Ratings Services considers this risk to be moderate, as ongoing changes in the

political landscape have not led to any material changes in the bank's financial condition since 1919, the year BND was created.

Outlook

The outlook is stable, mirroring that of the state of North Dakota, on whose guarantee the bank's creditworthiness depends. The bank plays a central role in the state's economic expansion plans. As such, unlike many state agencies and programs, given BND's mission, its continued existence is likely to be politically viable and even desirable even in tough economic times.

Profile

BND is headquartered in Bismarck and, measured by deposits, is the second-largest bank in the state. The bank is not federally insured and there is no oversight by federal authorities. Nevertheless, state legislation provides that all deposits of BND are guaranteed by the state. BND's primary deposit products are interest-bearing accounts for state and political subdivisions. Even though there is no federal oversight, the state's department of financial institutions examines BND at least once each 24 months and an independent auditor, Eide Bailey LLP, audits the annual financials. As a result of its unique position, the bank pays no taxes or federal deposit insurance, thereby boosting its profitability to higher levels. Risk-adjusted capitalization is strong, even considering state appropriations pending and a relatively large contingent commitment to transfer funds to the state general fund. Current legislation precludes transfers that would reduce capital levels below \$140 million. The bank has only one office and acts as the agent of several state-legislated programs, a lender, a depository for state agency funds, and a correspondent bank to private financial institutions in the state. As of Sept. 30, 2003, the bank employs 167 employees.

Ownership and Legal Status

The bank is controlled, operated, and managed by the state Industrial Commission, as mandated by the 1919 state legislature. Members of the Industrial Commission are the Governor, who acts as chairman; the Attorney General; and Agriculture Commissioner of the State of North Dakota. The bank has a seven-member Advisory board appointed by the governor. The members of the board consist of bankers and businesspersons who are knowledgeable in banking and finance. According to state legislature, the Advisory Board reviews BND's operations and makes recommendations to the Industrial Commission relating to BND's management, services, policies, and procedures.

Strategy

BND has one clear mission: "To deliver quality, sound financial services that promote agriculture, commerce, and industry in North Dakota." While its business goals are determined by its chartering objectives, which consist of being North Dakota's development bank, responsible for financing economic growth, the strategy used and vigor with which it is pursued are largely the discretion of bank management. Working with both state agencies and private banks in the state, BND has been far more proactive since the early 1990s in using its resources to promote charter objectives. Management has more aggressively utilized balance-sheet leverage, principally in lending. Management is likely to stay with the increased balance-sheet loan leverage in its pursuit of charter objectives. Thus far, bank management has been able to meet cited business objectives while maintaining a sound financial condition. While the bank's rating is based on the guarantee of the State, increased demand on earnings and bank capital resulting from the State's budgetary process will determine BND's financial profile.

Asset Quality

BND has adopted the mantra that lending is a fundamental key to its work as a development bank. To that end, throughout the 1990s and continuing through September 2003, BND has dramatically shifted its asset mix to favor loans. Total loans as a proportion of total assets has increased to 72% at Sept. 30, 2003, from an average of roughly 40% in the 1990s, and from a low of 21% in 1989. At the same time, liquid assets, consisting of cash and cash equivalents, repurchase agreements and federal funds sold, and securities classified as available for sale have correspondingly declined to 25% of total assets at Sept. 30, 2003, from an average of 30% in the 1990s.

Owing to its state sponsorship, the majority of the loans are guaranteed by federal and state agencies. At year-end 2002, nearly 53% of the loan portfolio carried a federal or state guarantee. BND utilizes these guaranty programs to reduce its risks to the agricultural economy. While BND is restricted from initiating and originating commercial loans exclusively for its own account, it participates in loans originated by other North Dakota-based commercial banks. At the end of December 2002, guaranteed student loans constituted 27% of the loan portfolio, totaling \$365 million, of which 98% of the student loans are guaranteed. Residential loans comprised 23% of the loan portfolio, totaling \$309.3 million, of which 84% of the residential loans are guaranteed. Agricultural loans represented 17% of the loan portfolio, totaling \$223 million, of which 25% of the agricultural loans are guaranteed.

Since the late 1970s and the early 1980s, BND has diversified its lending book away from a concentration in agricultural lending (principally real estate) that resulted in problems for the bank. With the declining proportion in agricultural lending, BND has become a more diversified lender. BND seems to have found a balance during the past few years with its various loan types, including 30% guaranteed student loans, about 30% commercial loans, approximately 23% residential loans and roughly 17% agricultural loans of the total loan portfolio. Even though agricultural lending is not as significant relative to other lending conducted by the bank, the entire state economy is affected to a large degree by the agricultural economy. As a result, much of BND's lending is indirectly related to the economy of agriculture.

Overall, portfolio quality metrics are adequate. Nonperforming loans (NPLs) plus loans 90-plus days past due amounts to 3.7% at Sept. 30, 2003. BND is below average compared to the average ratio of 1.3% of the 10 largest banks in North Dakota. This is to be expected given the bank's mandate to promote development. Nevertheless, excluding the guaranteed portion of the student loan NPLs and loans 90-plus days past due, the ratio falls to a manageable 2.7%. Charge-offs in the portfolio have been managed exceptionally well for the past few years. Net charge-offs to average loans has moderated to a low negligible amount for 2003 year-to-date, from a low peak of 10 basis points in 2001. Given these metrics, BND has good reserves with reserves-to-loans of 1.85% at Sept. 30, 2003.

Profitability

By most profitability measures, BND's earnings are strong, even though the metrics have been trending slightly downwards. The bank is tax-exempt, pays no deposit insurance premiums, and does not require the deposit-taking overhead of a large branch system. Annualized ROA was running at 1.61% through September 2003. This is slightly lower compared to 1.67% through nine months of 2002 and much lower than the 2.0% returns BND had posted throughout much of the 1990s. The average federal and state tax burden for commercial banks in North Dakota was 32% in 2002, and for comparative profitability, had BND's earnings been taxable, earnings would have been similarly lower. Adjusting earnings with the 32% tax rate, BND would have an ROA of 1.1% through September 2003. Additionally, the bank enjoys a

captive deposit base not dependant, as most commercial banks are, on expensive "brick and mortar" branches and the related overhead costs. The average overhead ratio for commercial banks in North Dakota was 54% in 2002. The overhead ratio for BND in 2002 was 30% and 32% through September 2003.

It is not surprising that BND's loan portfolio has a relatively low yield of 5.25% through the first nine months of 2003, compared to the average North Dakota commercial bank yield of 7.0%. This lower-yielding portfolio reflects the moderate risk profile and a charter that does not emphasize profitability. As a result of the low earning asset yields and the declining interest rate environment of the past few years, BND's net interest margin (NIM) of 2.1% for the first nine months of 2003 is substantially lower than the States' commercial bank average of 4.4%. The NIM has usually been low on a relative basis, generating less than 3.0% each year. Due to the nature of BND's asset-sensitive balance sheet, the NIM compression has accelerated since earning assets have repriced quicker than interest-bearing liabilities. As a result of the NIM compression, earnings have not grown as they did throughout the 1990s. Roughly 80% of BND's revenues are derived through net interest income. Nevertheless, BND has reduced its reliance on net interest income during the past few years by earning more noninterest income through servicing student and other loans.

Asset-Liability Management

As with other areas at BND, funding is unusual, posing special benefits and special risks unlike other commercial banks. By state law, all state funds and funds of state institutions are deposited with BND. BND accepts "private" deposits, which may come from any source, private citizens to the U.S. Government, which are not federally insured but are guaranteed by the state. While the legislation creates a captive deposit base, the duration of deposits are variable as they fluctuate with revenue and expense streams related to financing state government. Management has appropriately dealt with this uncertainty by maintaining a certain degree of liquidity and utilizing other forms of funding. As mentioned earlier, BND's balance sheet at Sept. 30, 2003, consists of 25% of liquid assets.

Deposits provide the majority of BND's funding, as deposits constitute roughly 63% of the funding base at Sept. 30, 2003; however, deposits do not fully fund BND's loan portfolio. At Sept. 30, 2003, loans to core deposits were 125.8%. Since the duration of the captive deposit base is variable, FHLB advances, repurchase agreements, and fed funds provide additional funding.

Capital

Capital on a risk-adjusted basis is strong, reflecting the moderate-risk asset mix and good earnings performance. As indicated by BND's regulatory capital ratios, the bank is well capitalized with 8.2% leverage, 14.7% Tier 1, and 15.9% total risk-based capital ratios reported at Sept. 30, 2003. Adjusted total equity-to-adjusted assets capital ratio had descended to 8.6% at year-end 2002 compared to 9.2% at year-end 2001, due to a transfer of capital of \$22 million to North Dakota's general fund. Nevertheless, as a result of BND's earnings power and a portion of the capital transfer returned to BND, this ratio improved to 9.2% at Sept. 30, 2003. BND's primary capital ratio, as defined by the State Banking Board, also remained well in excess of the minimum threshold. Current legislation precludes transfers that would reduce capital levels below \$140 million. If BND were to transfer its "excess" capital to the general fund, while maintaining the minimum \$140 million capital level, BND would have an adjusted total equity capital ratio of 8.4% at Sept. 30, 2003. BND's total capital transfers, or appropriations, consistently place it among the top five revenue generators for North Dakota's general fund.

Table 1 Balance Sheet Statistics														
		--Year ended Dec. 31--							Breakdown as a % of assets (adj.)					
(Mil. \$)	2003*	2002	2001	2000	1999	1998	-	2003*	2002	2001	2000	1999	1998	
Assets														
Cash and money market instruments	231	409	498	444	385	336		11.95	20.69	23.65	24.58	22.84	20.86	
Securities	304	235	330	192	235	428		15.74	11.92	15.64	10.63	13.93	26.59	
Nontrading securities	304	235	330	192	235	428		15.74	11.92	15.64	10.63	13.93	26.59	
Mortgage-backed securities included above	144	36	46	10	5	12		7.44	1.83	2.19	0.55	0.27	0.73	
Customer loans (gross)	1,398	1,330	1,276	1,157	1,056	836		72.36	67.36	60.56	64.02	62.60	51.94	
Public sector/government	38	26	22	25	21	35		1.94	1.31	1.03	1.41	1.25	2.16	
Residential real estate loans	311	309	271	213	188	114		16.08	15.66	12.88	11.79	11.17	7.08	
Other consumer loans	371	365	399	377	336	293		19.21	18.48	18.93	20.84	19.90	18.20	
Commercial real estate loans	89	77	64	65	62	61		4.62	3.88	3.02	3.62	3.68	3.80	
Commercial/corporate loans	382	380	357	328	312	229		19.76	19.24	16.93	18.17	18.48	14.21	
All other loans	208	173	164	148	137	104		10.75	8.78	7.76	8.19	8.13	6.48	
Loan loss reserves	26	25	24	22	20	19		1.34	1.27	1.14	1.24	1.19	1.18	
Customer loans (net)	1,372	1,305	1,252	1,134	1,036	817		71.02	66.09	59.43	62.78	61.41	50.76	
Earning assets	1,779	1,775	1,864	1,620	1,541	1,470		92.12	89.88	88.44	89.69	91.33	91.33	
Fixed assets	5	5	4	4	3	3		0.25	0.26	0.19	0.20	0.17	0.19	
Accrued receivables	16	18	21	25	21	20		0.85	0.89	0.97	1.39	1.22	1.26	
All other assets	4	3	3	7	7	6		0.19	0.14	0.12	0.40	0.43	0.35	
Total reported assets	1,932	1,974	2,107	1,807	1,687	1,609		100.00	100.00	100.00	100.00	100.00	100.00	
Adjusted assets	1,932	1,974	2,107	1,807	1,687	1,609		100.00	100.00	100.00	100.00	100.00	100.00	
								Breakdown as a % of liabilities + equity						
	2003*	2002	2001	2000	1999	1998		2003*	2002	2001	2000	1999	1998	
Liabilities														
Total deposits	1,142	1,071	1,209	1,136	911	944		59.10	54.24	57.35	62.87	53.98	58.64	
Noncore deposits	30	65	65	65	65	65		1.55	3.29	3.08	3.60	3.85	4.04	
Core/customer deposits	1,112	1,006	1,144	1,071	846	879		57.55	50.94	54.26	59.27	50.12	54.60	
Repurchase agreements	205	297	316	215	251	309		10.59	15.03	14.98	11.91	14.88	19.23	
Other borrowings	409	421	400	254	363	204		21.17	21.33	18.96	14.08	21.52	12.66	
Other liabilities	22	37	13	48	23	12		1.16	1.86	0.62	2.67	1.37	0.76	
Total liabilities	1,777	1,825	1,937	1,653	1,548	1,469		92.02	92.45	91.91	91.53	91.75	91.30	
Total shareholders' equity	154	149	170	153	139	140		7.98	7.55	8.09	8.47	8.25	8.70	
Common shareholders' equity (reported)	154	149	170	153	139	140		7.98	7.55	8.09	8.47	8.25	8.70	
Share capital and surplus	44	44	44	44	44	44		2.28	2.23	2.09	2.44	2.61	2.73	
Revaluation reserve	(1)	1	0	0	(1)	0		(0.04)	0.04	0.01	0.02	(0.08)	0.01	
Retained profits	111	104	126	109	97	96		5.74	5.28	5.99	6.02	5.73	5.95	
Total liabilities and equity	1,932	1,974	2,107	1,807	1,687	1,609		100.00	100.00	100.00	100.00	100.00	100.00	
Less revaluation reserve,														

Average customer loans	1,338	1,279	1,193	1,085	926	711						
Average earning assets	1,777	1,819	1,742	1,581	1,505	1,246						
Average assets	1,953	2,041	1,957	1,747	1,648	1,386						
Average total deposits	1,106	1,140	1,172	1,023	927	832						
Average interest-bearing liabilities	1,772	1,856	1,765	1,565	1,491	1,232						
Average common equity	152	160	162	146	140	134						
Average adjusted assets	1,953	2,041	1,957	1,747	1,648	1,386						
Other data												
Number of branches	1	1	1	1	1	1						
Off-balance-sheet credit equivalents	360	325	341	342	315	250						
*Data as of Sept. 30, 2003. Ratios annualized where appropriate. Certain raw data items used within the above financial spreads have been obtained from SNL Financial LC.												

Table 3 Ratio Analysis						
		--Year ended Dec. 31--				
	2003*	2002	2001	2000	1999	1998
ANNUAL GROWTH (%)						
Customer loans (gross)	6.77	4.20	10.35	9.50	26.40	34.02
Loss reserves	3.97	4.73	6.84	11.53	6.26	8.48
Adjusted assets	(2.89)	(6.31)	16.66	7.07	4.86	38.42
Customer deposits	13.98	(12.05)	6.81	26.62	(3.74)	22.10
Tangible common equity	6.02	(12.92)	11.48	8.53	0.69	8.50
Total equity	4.51	(12.54)	11.40	9.89	(0.47)	8.57
Operating revenues	(3.18)	(1.76)	3.46	8.75	4.96	11.16
Noninterest expense	2.92	3.34	9.05	5.45	(0.85)	4.78
Net operating income before provisions	(5.84)	(3.83)	1.35	10.05	7.45	14.13
Loan loss provisions	(54.66)	(18.52)	0.00	68.75	(5.88)	183.33
Net operating income after provisions	(2.50)	(2.63)	1.46	6.97	8.25	10.15
Pretax profit	(2.50)	(2.63)	1.46	6.97	8.25	10.15
Net income	(2.50)	(2.63)	1.46	6.97	8.25	10.15
	2003*	2002	2001	2000	1999	1998
PROFITABILITY (%)						
Interest Margin Analysis						
Net interest income (taxable equiv.)/avg. earning assets	2.06	2.18	2.39	2.62	2.45	2.72
Net interest spread	2.06	2.24	2.44	2.57	2.41	2.68
Interest income (taxable equiv.)/avg. earning assets	4.47	4.96	6.57	7.41	6.60	7.05
Interest income on loans/avg. total loans	5.25	6.10	7.33	8.33	7.69	8.13
Interest expense/avg. interest-bearing liabilities	2.42	2.73	4.13	4.84	4.19	4.37

Interest expense on deposits/avg. deposits	1.44	2.00	3.67	4.79	3.86	3.94
Revenue Analysis						
Net interest income/revenues	76.59	80.24	82.81	85.14	82.47	79.69
Market-sensitive income/revenues	0.00	0.00	0.00	(1.19)	(0.86)	0.06
Noninterest income/revenues	23.41	19.76	17.19	14.86	17.53	20.31
Personnel expense/revenues	15.91	15.31	14.27	14.25	15.04	14.98
Noninterest expense/revenues	32.31	30.40	28.90	27.42	28.28	29.94
Noninterest expense/revenues less investment gains	32.31	30.40	28.90	27.10	28.04	29.96
Expense less amortization of intangibles/revenues	32.31	30.40	28.90	27.42	28.28	29.94
Expense less all amortizations/revenues	30.07	28.35	27.25	26.15	27.19	28.74
Net operating income before provision/revenues	67.69	69.60	71.10	72.58	71.72	70.06
Net operating income after provisions/revenues	65.60	65.15	65.73	67.02	68.14	66.07
New loan loss provisions/revenues	2.08	4.45	5.37	5.55	3.58	3.99
Pretax profit/revenues	65.60	65.15	65.73	67.02	68.14	66.07
Net income/revenues	65.60	65.15	65.73	67.02	68.14	66.07
	2003*	2002	2001	2000	1999	1998
OTHER RETURNS						
Pretax profit/avg. risk assets (%)	3.10	3.25	N.A.	N.A.	N.A.	N.A.
Net income/avg. risk assets (%)	3.10	3.25	N.A.	N.A.	N.A.	N.A.
Revenues/avg. risk assets (%)	4.72	4.98	N.A.	N.A.	N.A.	N.A.
Net operating income before loss provisions/avg. risk assets (%)	3.19	3.47	N.A.	N.A.	N.A.	N.A.
Net operating income after loss provisions/avg. risk assets (%)	3.10	3.25	N.A.	N.A.	N.A.	N.A.
Net income before minority interest/avg. adjusted assets	1.61	1.58	1.69	1.87	1.85	2.03
Net income/avg. assets + securitized assets	1.61	1.58	1.69	1.87	1.85	2.03
Personnel expense/branch (mil. currency unit)	7.61	7.57	7.18	6.93	6.72	6.38
Noninterest expense/branch (mil. currency unit)	15.46	15.02	14.54	13.33	12.64	12.75
Cash earnings/avg. tang. common equity (ROE) (%)	21.41	20.85	20.99	22.63	22.07	21.34
	2003*	2002	2001	2000	1999	1998
FUNDING AND LIQUIDITY (%)						
Customer deposits/funding base	63.33	56.24	59.44	66.70	55.46	60.31
Total loans/customer deposits	125.74	132.22	111.61	108.02	124.90	95.12
Total loans/customer deposits + long-term funds	83.45	84.39	74.48	78.24	78.36	68.37
Customer loans (net)/assets (adj.)	71.02	66.09	59.43	62.78	61.41	50.76
	2003*	2002	2001	2000	1999	1998
CAPITALIZATION (%)						
Adjusted common equity/adjusted assets	8.02	7.51	8.08	8.45	8.34	8.68

Adjusted common equity/adjusted assets + securitization	8.02	7.51	8.08	8.45	8.34	8.68
Adjusted common equity/risk assets	14.66	15.27	16.83	N.A.	N.A.	N.A.
Adjusted common equity/customer loans (net)	11.30	11.36	13.59	13.46	13.58	17.11
Internal capital generation/prior year's equity	3.04	(12.90)	11.45	8.62	0.68	8.50
Tier 1 capital ratio	14.66	15.27	16.83	N.A.	N.A.	N.A.
Regulatory total capital ratio	15.93	16.53	18.09	N.A.	N.A.	N.A.
Adjusted total equity/adjusted assets	9.17	8.63	9.17	9.65	9.46	9.83
Adjusted total equity/adjusted assets + securitizations	9.17	8.63	9.17	9.65	9.46	9.83
Adjusted total equity/risk assets	16.76	17.55	19.11	N.A.	N.A.	N.A.
Adjusted total equity plus LLR (specific)/customer loans (gross)	12.94	13.03	15.22	15.14	15.22	18.99
Common dividend payout ratio	85.55	168.34	47.01	63.16	96.88	61.08
	2003*	2002	2001	2000	1999	1998
ASSET QUALITY (%)						
New loan loss provisions/avg. customer loans (net)	0.07	0.17	0.23	0.25	0.17	0.24
Net charge-offs/avg. customer loans (net)	0.00	0.08	0.10	0.04	0.04	0.03
Loan loss reserves/customer loans (gross)	1.85	1.89	1.88	1.94	1.90	2.26
Gen. loan loss reserves/customer loans (net of specifics)	1.59	1.67	1.81	1.87	1.79	2.21
Credit-loss reserves/risk assets	2.45	2.58	2.37	N.A.	N.A.	N.A.
Nonperforming assets (NPA)/customer loans + ORE	3.65	3.40	2.95	2.56	3.83	3.47
NPA (excl. delinquencies)/customer loans + ORE	1.78	1.72	1.58	1.50	1.55	1.75
Net NPA/customer loans (net) + ORE	1.83	1.54	1.09	0.64	1.96	1.23
NPA (net specifics)/customer loans (net specifics)	3.39	3.18	2.88	2.50	3.72	3.42
Loan loss reserves/NPA (gross)	50.69	55.50	63.63	75.62	49.71	65.32
*Data as of Sept. 30, 2003. Ratios annualized where appropriate. N.A.--Not available. Certain raw data items used within the above financial spreads have been obtained from SNL Financial LC.						

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